

Duffy Transition Committee Fiscal Health Subcommittee

In order to clarify our role and limit our task to what was practical in the time available, the Subcommittee developed the following definition of “fiscal health” and refined charge:

What is “fiscal health?”

A fiscally healthy City has stable long term revenue adequate to fund its reasonable expenses.

Stable long term revenue:

- is projected to fully fund operating expenses over a three year planning horizon
- with long term borrowing only for capital expenses at a rate that follows depreciation reduction, is limited by interest rate impact and with growth limited by reliably estimated revenue growth
- short term borrowing for working capital that is limited by interest rate impact and only against reliably anticipated tax receipts
- includes revenue from all reasonably estimated sources, but matches one-time revenue against one-time expense
- results from a rigorous budget process that realistically estimates revenue and
- imposes a limit on revenue increases (taxes & fees) by recognizing the burden on taxpayers and the impact on the City’s economic competitiveness.

Reasonable expenses are those that result from:

- a rigorous budget process that realistically estimates expenses
- reserves adequate to maintain working capital
- a balance of proposed expenditures against the capacity to generate revenue using established City priorities and
- includes or anticipates expenditures within established City priorities sufficient to fund programs to the economic development and quality of life of the City beyond providing basic services.

Our charge is to provide transition assistance to Mayor-elect Duffy by assessing the overall “fiscal health” of the City, the issues it presents and its potential impact on the Duffy “Impact Rochester” platform. We are not charged with providing advice concerning the specifics of the City’s finances or budget. To perform our charge the Committee will:

- obtain an overview of the current status of the City’s finances
- obtain a estimate of the financial prospects of the City for the 2006-2007 budget
- obtain an estimate of the financial challenges facing the City for the next three years
- identify the issues this background presents in the upcoming year for the

- priorities identified in Mayor-elect Duffy's "Impact Rochester" platform
- identify the issues this background presents for the "fiscal health " of the City over the next three years
- to the extent possible within the time and resources allotted, identify mechanisms to address the issues identified above.

Fiscal Overview Developed by Subcommittee

- Information on the finances and budget appeared to be complete and detailed .
 - Received a useful and competent response from the City staff.
 - Our review was not an audit, but audits and credit reviews are routinely done and support competent administration and accurate reporting.
- There is a pattern of balanced budgets and modest year end surpluses.
- A good credit rating has been maintained by prudent borrowing, budget discipline and consistent and complete reporting.
- Revenue circumstances
 - Property values declined over more than a decade, until the 2004 reappraisal. It added over \$300 million to the residential base, while a decline, although modest, continued in the commercial base. When adjusted for inflation or compared to most other places in the country outside of upstate New York, the decline is dramatic.
 - Modest increases in the tax rate over the last decade have been offset by a decline in property values producing relatively flat revenue. The property tax rate increases have increased the burden on the property owner, but have done little to raise total revenue. The property tax revenue in 1995-96 was \$136.2 million and by 2003-04 it had decreased to \$131.7 million.
 - The state-required equalization process between the commercial and homestead property taxpayer classes keeps tax revenue flat and makes tax increases politically difficult.
 - The constitutionally determined property tax margin has steadily declined. For the 2005-06 fiscal year, the margin between the amount the City could constitutionally collect in taxes and the amount it anticipates collecting is a razor-thin \$13 million.
 - There has been a steady pattern of fee increases (water, refuse, local works - \$73 million in 2005-06) to avoid pressure on the constitutional property tax limit and to pick up revenue from property not subject to

property tax. From 1994-95 to 2005-06, these fees increased 36% or 3.2% per year (slightly more than the rate of inflation) for the typical homeowner.

- Property taxes and city-imposed fees are approaching a financially practical limit even though property tax rates (the homestead 1995-96 rate of \$16.18 per thousand dollars of assessed value increased 24.4% or 2.7% per year to \$20.12 in 2004-05; commercial 1995-96 rate of \$42.11 per thousand dollars of assessed value increased 5.2% or .6% per year to the 2004-05 rate of \$44.32) and fee increases have not significantly outpaced inflation over a ten year period and lower property values have mitigated the impact of rate increases. City property values and incomes have not kept pace with inflation, the City's population has declined from 332,488 in 1950 to 213,400 in 2004 and City residents are of modest means (\$27,123 median income in 2000, with 26 % below the poverty level).
- Sales tax revenue, shared with Monroe County under the Morin-Ryan Agreement, has become increasingly important due to the normal growth and rate increases in 1992 and 1993. It was \$118 million in 2004-05 and is projected to be within \$3 million of the real property tax receipts in 2005-06.
- While state aid to Rochester has increased significantly (1996-97 \$28.9 million to 2005-06 \$59.7 million), and the 2006-07 state budget provides evidence of a commitment to close the substantial lag that exists among the amount allocated to Rochester and the amounts allocated to other upstate cities on a per capita basis, it cannot be assumed to be a dependable stream of revenue. Unlike the sales tax, it is not linked to a dedicated revenue source, but is dependent on an annual appropriation from the state's General Fund. The commitment of the governor and the state legislature then in office, the health of the state's economy and the tax revenues it generates and competing policy, political and regional interests are variables that are mostly beyond the control of the City.
- Federal assistance through the Community Block Grant Program has become increasingly important as flexible support for community development activities. The current level of \$13.3 million is scheduled to decline to \$11.5 million (a 12% reduction) due to pressures on the federal budget.
- The City is increasingly dependent on revenue sources it does not control (State aid, Federal programs and sales tax).
- Borrowing has not been used to fund operating deficits, but the available margin

(constitutional limit) has decreased from \$562 million in 1994-95 to \$146 million in the 2005-06 largely due to school and War Memorial construction that required borrowing in excess of depreciation.

- For several years, there has been a substantial projected deficit that has been closed by modest cost reductions, but principally by increasing reliance on sales tax, fee revenue and State aid.

In the 2005-06 the gap of \$28.4 million was projected to be closed by:

Use of reserves	\$6.8
State aid increase	\$6
Fee increases	\$2.5
Property tax increase	\$4
Sales Tax growth	\$1.6
Other revenue increases	<u>\$4.1</u>
Total revenue increase	\$25
Cost reductions	\$3.4

- Cost reduction is complicated by the components of the cost structure.
 - The number of full time equivalent employees has increased from 3,316 in 1996 to 3,354 in 2005. It reached a high of 3,557 in 2002 and has been steadily declining since. The principal increases since 1996 have been 48 in police and 67 in administration devoted largely to quality of life programs. The increases were partially offset by reductions in other areas.
 - City School District full-time equivalent employment grew from 5,334 in 1996 to 5,864 in 2005.
 - General Fund spending (expenditures dependent on tax and fee receipts and for which direct reimbursement from another source is not received) excluding City school support, increased from \$277 million in the 2003-04 to \$303.7 in 2005-06, while total spending increased from \$370.6 million to \$403.4 million.
 - Of the \$303.7 million of General Fund spending, 21% is for Police, 13% for Fire and 7% for debt service, leaving only \$179.4 million for everything else. Viewed another way, 65% of the available revenue not dedicated to a specific purpose is spent on schools, police and fire protection.
 - State mandated retirement expenses have increased from \$9.2 million in 2003-04 to \$24.5 million in 2005-06. This is expected to stay high, but not grow significantly.
 - City controlled, but largely covered by union contracts, medical and other

benefits have increased in cost from \$33.8 million in 2003-04 to \$43.2 million in the 2005-06. Projections point to continued growth. Post-retirement benefit costs, which must be estimated and reported for the first time within the next several years, will be very substantial and are unfunded.

- The concentration of poverty in the City has increased the demand for community development, housing and police services at the same time as it has decreased the City's financial resources.
- As part of its annual budget process the City prepares a multi-year projection that does not include any growth in the contribution to the School District. The most recent projection is an attachment.
 - The projection is conservative in that it holds the tax rate and other revenue sources constant, although a historical rate of growth in sales tax revenue is included. Expenses are projected to grow with general inflation, except for health care that is projected to grow by 15% a year.
 - The result is a projected deficit that starts at \$28.2 million in the 2006-07 and grows to 105.9 million in the 2010-11.
 - The conservative nature of this projection and the lack of any anticipated management intervention, along with the City's history of managing the projected deficit, would indicate that this projection is overstated. However, given the City's control over its revenues, even if the projection was cut in half it would create a crisis.

Subcommittee Conclusions

- The City's financial management has been conservative and well done.
- The City has generally met the Subcommittee's definition of "fiscal health" in the recent past, but has been struggling to do so and may soon lose that struggle.
- The financial pressures that have dominated the City's recent history and threaten to grow in the future are largely the product of a fundamental change in the population demographics, declining property values and a declining commercial and industrial base, made worse by State labor and employee benefit policies that constrain the City's ability to manage its operations and workforce.
- While the City has moderated the growth of expenditures in the areas it can control, most of the ability to balance recent budgets has come from revenue growth other than the property tax. These are revenues over which the City has

limited control.

- In some of the areas of expense growth, principally pension and health care, the City has been unable to respond in the same manner as the private sector, because of collective bargaining agreements, state constitutional limitations and Taylor Law requirements. The City now has personnel benefits and costs that are among the most generous in the community.
- In some areas of the greatest cost, principally police and fire services, the City can exercise little control and the ability of the City and its taxpayers to pay is not a consideration, because of binding arbitration for police mandated by the state's Taylor Law and state mandated pension and disability practices for firefighters.
- This has left the City with uncertain control over much of its expense base and the sources of revenue that have the potential to grow in the reasonably near future.
- The City's capacity to cobble together a solution from various sources of cost reduction and additional revenue is rapidly running its course.
- Without fundamental changes, the City is likely to face a financial crisis it cannot manage within the next several years.
- The fundamental changes will have to cover all areas that affect the City's fiscal health.
 - Expense control has been practiced in most areas, but this must now shift to expense reduction. This can only happen if the City stops doing some of the things it now does or it does them in a significantly different manner. Chipping away at the issue by an across the board budget reduction or hiring freezes is unlikely to get the job done, particularly as the City will need to convince other governments that it needs greater assistance.
 - The solution should include consolidation of services with other governments where it reduces, rather than shifts costs. That said, there needs to be some caution about how much consolidation can be accomplished and how quickly. It is vital to preserve the public safety and quality of life services that keep the City viable and the demand for these services may well increase.
 - The City must conduct a complete inventory of the services it provides, determine which of those services is essential, look for ways to manage those services more efficiently and be prepared to eliminate or reduce non-essential functions. For instance, a reduced population, modern building codes and construction materials may reduce the demand for

some fire services.

- The growth of health care benefits will have to be brought under better control and made more comparable to the benefits of the citizens who pay the bill. The projected cost increases for this item alone could drive the City beyond its ability to meet its obligations. At a minimum, it is time for the City to shift to experience rating and to consider a single carrier contract and self-insurance. These changes can substantially reduce costs with minimal impacts on coverage.
- Retiree health benefits pose a particular problem and will have a negative impact on the City's balance sheet next year when mandated accounting rules require the City to record the projected future costs of these benefits in its financial statements.
- It is critical to vigorously pursue economic development to begin to rebuild the tax base and support the quality of life of city residents. This will be a long term solution that will require aggressive attraction and retention programs. This will require a business-committed city ready to work with community economic development partners to aggressively market its attributes in order to overcome some of its inherent disabilities. There is some limit to what this activity can deliver in the near future. At the current commercial tax rate (\$44.79/1000), it takes \$25 million in tax base to produce a little over \$1 million in taxes; assuming no tax abatement to stimulate development. At the current homestead rate (\$20.99/1000) it takes over a \$50 million increase in the tax base to produce \$1 million in taxes. Economic development is important beyond its immediate impact on the tax base, but we need to be careful not to look to this as the total answer.
- There is some ability to increase tax revenue and fees from existing sources, particularly if the value of the existing tax base begins to grow at least with inflation. Economic development can help make this happen. However, there is little room either legally or practically to increase rates or charges.
- The City has demonstrated an extraordinary commitment to the City School District. While the City receives less per capita in state aid than Buffalo or Syracuse, it continues to provide significantly more funding to its School District. Given the City's current financial situation, it is not and will not be capable of increasing its contribution to the School District in the near future. In this regard, we agree with the recommendation made last year by the Blue Ribbon Panel chaired by RIT President Dr. Al Simone.
- Even assuming success with the efforts described above, there will need

to be a significant increase in aid from the State of New York. The current model for funding upstate cities from the property tax and whatever other sources can be cobbled together is no longer viable. As the City's tax base shifts from one of a mix of industrial, commercial and residential to one of mostly smaller commercial, residential and substantial tax exempt property, the historical funding model can no longer pay for the increasing costs of a concentrated urban center. There needs to be new broader based funding support. Only the State, with its income and similar taxes collected from a broad economic base, can provide that support while minimizing the regressive nature of the tax burden. Rochester has a particular claim to increased aid because it now receives substantially less per capita than Syracuse and Buffalo. If this were equalized, Rochester would receive \$35 million more each year. This increase needs to be in the form of a regular reliable commitment that will allow the City to plan and to discourage it and its various constituents from looking to the State each year for more. It should be a fundamental change in the way the City is funded that, along with the changes described above, will allow it to regain fiscal health.

Fiscal Health Subcommittee Members:

Ron Behan
Robert Bergin
Ursula Burns
Jose Coronas
Sergio Esteban
Paul Haney
Robert W. Hurlbut, Jr. - Vice Chairman
Peter Kaplan
Jennifer Leonard
David Mack
Patrick Malgieri
Ron Paprocki
Thomas S. Richards, Chairman
Geoff Rosenberger
Don Tomeny

Attachments

- Financial Presentation by Budget Director Ansbrow dated 12/7/05
- Financial Presentation to John Cape, Director New York State Division of Budget dated 10/24/05
- Standard and Poor's Credit Profiles for Rochester dated 11/19/2004, 2/18/04, 9/2/03, 3/12/02, 2/8/01 and 10/7/99
- Moody's Investor Services Credit Profiles for Rochester dated 2/11/04, 8/27/03, 1/26/01, 10/11/99 and 10/8/97
- Revenue Summary from 2005-06 Budget
- Expenditure Summary from 2005-06 Budget
- Multi-Year Projection from 2005-06 Budget
- Fund Summary from 2005-06 Budget
- Management Chart with 2005-06 Budget allocations
- Capital Improvement Program Category Summary for 2005-06
- Department of Community Development Community Development Block Grant Program Presentation of Joe Mustico
- Consolidated Community Development Plan, Annual Action Plan, Estimated Revenue Summary

Material reviewed and not attached

- Duffy Campaign Impact Rochester Report
- City of Rochester Comprehensive Annual Financial Reports for Fiscal Years Ended 6/30/04 and 6/30/05.
- Rochester City School District Comprehensive Annual Financial Report for Year Ended 6/30/05
- Consolidated Community Development Plan, Strategic Plan 2005-06 thru 2009-10
- City of Rochester Financing Prospectus dated 9/30/05.
- Rochester Census Profiles and Trends prepared by Bureau of Planning March, 2002
- City of Rochester 2005-2006 Budget

Presentations

- Richard Hannon, Deputy Mayor
- William Ansbrow, Budget Director
- Vincent Carfagna, Finance Director
- Joe Mustico, Assistant to the Commissioner of Community Development